U.S. Small Business Administration

SBA

Championing America's Entrepreneurs

SBIC TechNotes

January 1998 - Number 1

Technology transfer and seed capital investments

The Investment Division recently addressed the question of whether a particular structure of seed capital investment involving technology transfer was permissible under SBIC regulations. Since other SBICs may be contemplating similar transactions, we thought it useful to disseminate the position that we took in this instance. Once we have gained sufficient experience with the various relevant factors from actual practice, we expect to modify our Regulations to cover such transactions more explicitly.

In this particular case, a promising technology was identified at a university research foundation, and the SBIC agreed to sponsor additional research on it in exchange for an option to obtain an exclusive, worldwide license to commercialize the results. A shell corporation was formed by the SBIC to receive the SBIC's investment, to contract for the research from the university research foundation in exchange for the option, and implement the commercialization if the research proves to be successful.

As you probably recognize, the ownership aspect of the transaction raises significant issues under the Program's fundamental concept that SBICs are **not** intended to operate business enterprises or to function as holding companies exercising control over such enterprises. The transaction also raises a second issue as to whether the concern which was formed for the project is a passive business. At the same time, a project such as this clearly contributes to achieving the Program's overall public policy objective "to improve and stimulate the national economy" in that, if successful, it will result in the creation of a viable small business, with its increased employment and tax revenues, and in the application of technology to benefit the Nation's economy.

We concluded in this case that the SBIC was not violating Sec. 102 of the Small Business Investment Act or §107.865(a) of the Regulations when it was the organizer and sole owner of a company under the following conditions:

1. The concern is a seed-stage operation formed to develop, whether internally or through third-party contracts, *and then exploit*, some form of intellectual property.

2. Further development of the intellectual property will, in the near future,

require more funds than the SBIC is in a position to invest; and *the necessity of raising additional venture capital will automatically dilute, and eventually eliminate, the SBIC's control position* before the concern reaches the stage at which it can begin to exploit the intellectual property.

3. Exploitation of the intellectual property will *require a dedicated non-Associate management team with a significant present or potential equity interest in the concern.*

In other words, a viable, independent operating business is expected to be created by the transaction.

We believe that it is important to distinguish this situation from one in which an SBIC and/or its Associates owns substantially all of the equity of either an operating company or a company formed to acquire an operating company, and where the SBIC expects to divest itself of its control position by means of a sale of the securities it owns (rather than by dilution from transactions which inject additional capital in the concern to accommodate its growth), and proposes to operate the business in the meantime until someone makes an acceptable offer to buy it.

As to the second question of the concern's passive nature, we were persuaded by the facts in the case and the representations of the SBIC that this was only a temporary interim condition which would be corrected automatically when the intellectual property which the concern was formed to exploit was developed to the point that licensing or production became feasible. Again, it is important to distinguish this situation from a one-shot assignment of a license, or a one-shot sub-licensing arrangement, after which the concern's activity would be largely limited to receiving royalty checks and declaring dividends.

Accordingly, we concluded that ₃107.720(b) of the Regulations was not violated under circumstances where:

1. The concern is formed for the purpose of, first, financing the development of seed-stage intellectual property and, secondly, exploiting that property; the concern is **not** formed for the purpose of financing the development of seed-stage intellectual property for which some third-party has either a license or an option to acquire a license; nor is it formed to hold a perfected technology, license or trademark with the objective of a one-time transfer to another company and the subsequent collection of royalties, license fees, etc.

2. At such time as the intellectual property is sufficiently developed, the SBIC reasonably expects the concern to be actively engaged in business,

whether by manufacturing a product that will be distributed by others, by distributing a product manufactured by others, or by actively seeking out new licenses for applications of the intellectual property in question.

In the case discussed above, there was no Associate or Affiliate relationship between the SBIC and the university research foundation. We would not look favorably upon an SBIC funding research for an affiliated university, foundation or other entity.

This is a complex area in which we are attempting to accommodate transactions which legitimately serve the public policy objectives of the Program without opening the Program to abuses. If you are contemplating a future investment transaction of this type, you should discuss it first with your Investment Division analyst to ensure that we agree with your interpretation.

The information provided in this SBIC Tech Note is the Investment Division's effort to summarize SBA's resolution of a recent SBIC matter. The information provided expresses the Division's resolution of this particular matter only. Any different facts or conditions might result in a different conclusion by the Division.